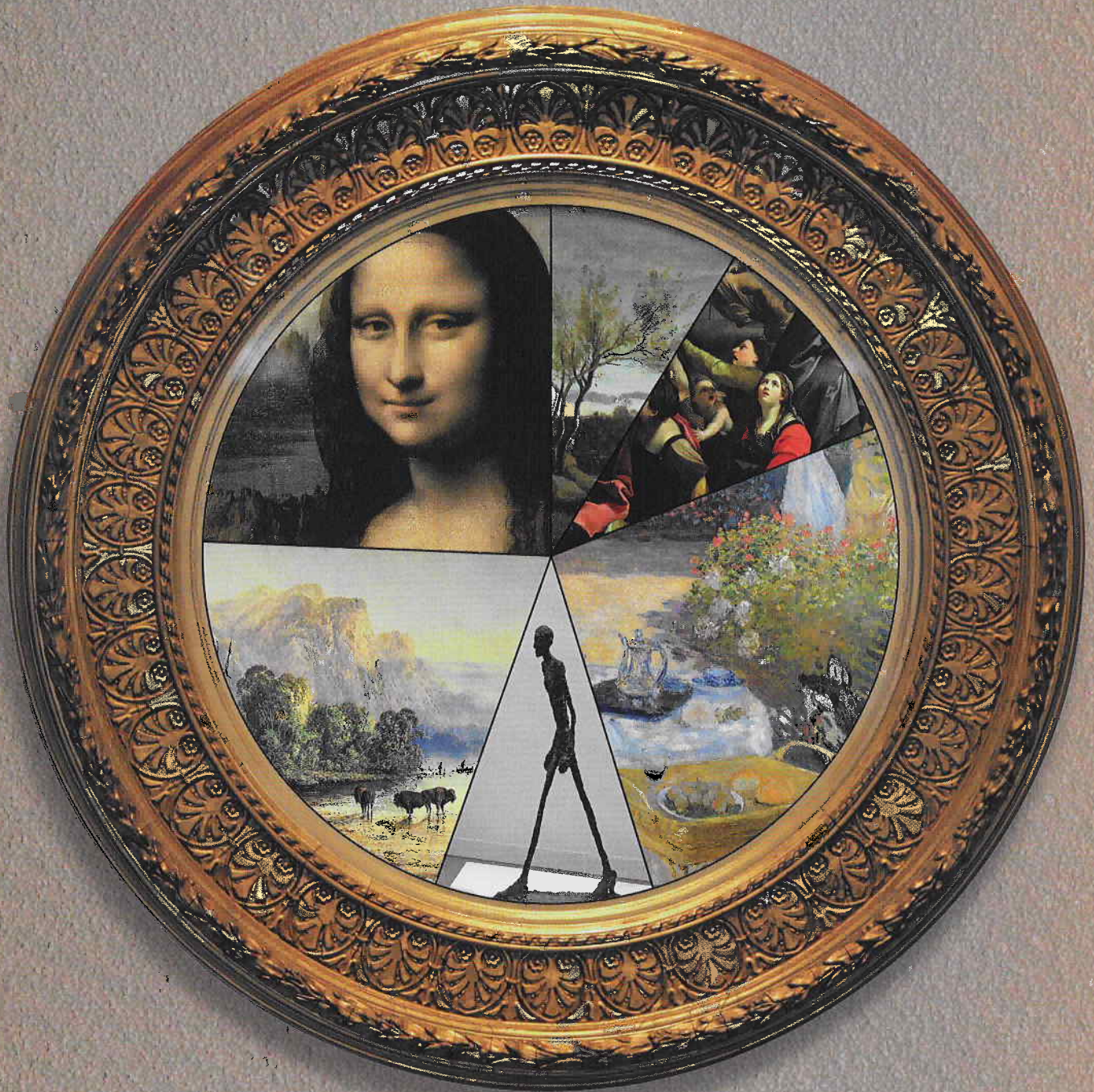


# CFA INSTITUTE

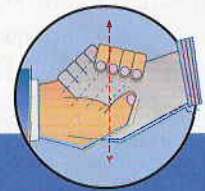
May/June 2010

- The future of fiduciary management
- Did capitalism cause the meltdown?
- The European Investors' Working Group
- Investor risk tolerance after the crisis
- Will a new model revive the CMBS market?
- Shareholder activism in a post-Lehman world



## The Fine Art of Investing

Should this portfolio hang in your client's gallery of assets?



# Private CLIENT CORNER

PROFESSIONAL PRACTICE

## The Fine Art of Investing Is art a good way to diversify a client's portfolio?

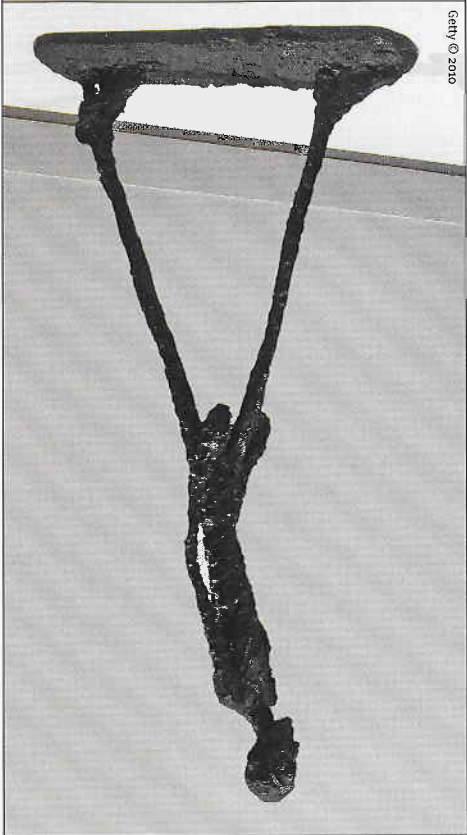
BY ED MCCARTHY

**F**or sale: A six-foot-tall bronze sculpture of a spindly walking man. Recently changed owners for £45 million. Serious inquiries only. You won't find this ad on Craigslist, but the 1960 Alberto Giacometti sculpture "Walking Man I" did sell for £45 million in early February 2010 at a Sotheby's auction in London. The purchase price greatly exceeded expectations and is being viewed as a harbinger of a possible resurgence in the art market. If you've had the experience of having time stand still while admiring a painting or sculpture, art's allure will need no explanation, but there are other motivations. For those who like to display their wealth, collecting pieces with a recognized value can create the desired impression. Art ownership can also appeal to philanthropists who collect with a goal of sharing with the public. And in many instances, the long-term investment returns of owning art can be substantial. Nonetheless, the challenges of investing in art are significant. So what do you do when a client expresses a desire to begin investing in art?

### The Fallacy of a Unitary Market

One response is to ask what type of art the client is considering. The first thing to know is that the notion of an "art market" is misleading. Art is defined by four broad categories: fine art, decorative art, antiques, and collectibles. According to David Kusin, owner of art research firm Kusin & Company in Dallas, Texas, what is often referenced as a single entity is an aggregation of approximately 150 discrete, independently moving

markets. "When you compare 19th century American landscape painting, for instance, with 19th century French landscape painting, you find that the markets and the prices are really very, very different," he says. "[That's why] you can't use sweeping terms like the 'art market.' You have to go down several layers below that." Such diversity is daunting to a novice, but it's also "one of the reasons why [art] actually can make an extremely useful place for diversifying risk—because there are so many things working at different levels at founder of Arts Economics (a research and consulting firm focused on the art economy) in Dublin, Ireland, and



The Alberto Giacometti sculpture "Walking Man I" was recently sold at auction for £45 million.

Geddy © 2010

- The term "art market" is misleading because the market encompasses numerous submarkets with distinct characteristics.
- The unique features of the art market and the transaction costs create additional risks for casual investors and investment opportunities for more knowledgeable participants.
- Studies of art's investment properties show that returns vary with the holding period but have exhibited a low or negative correlation with financial markets.

### KEY POINTS

editor of the book *Fine Art and High Finance*. Although recent headlines have focused on the contemporary art market's recent poor performance, this category is only one submarket. "There are other sectors: Old Master, 18th century, French furniture—all these things," says McAndrew. "They've been going on completely different paths—not as spectacular and not as headline grabbing. But they've been doing quite well recently, so it is sort of a misnomer to even discuss the art market as a whole. It's actually a bit like discussing the stock market. There are many companies, and some of them are doing well and some of them aren't."

Art transactions occur in two distinct channels: auctions and dealers, with each having roughly half the market. Christie's and Sotheby's are the largest and best-known auction houses, and each covers a wide range of markets. Dealers are smaller operators and focus on fewer submarkets. Sale prices from auctions can be tracked, but dealer sales and direct buyer-to-seller transactions are not disclosed. When the transaction's details are public information, it's still important to realize that, unlike shares in a company, each art object is unique. Additionally, art tends to "disappear" into collections for long periods, which means that intra-sale valuations require private appraisals. "I did some research a few years ago and found that the

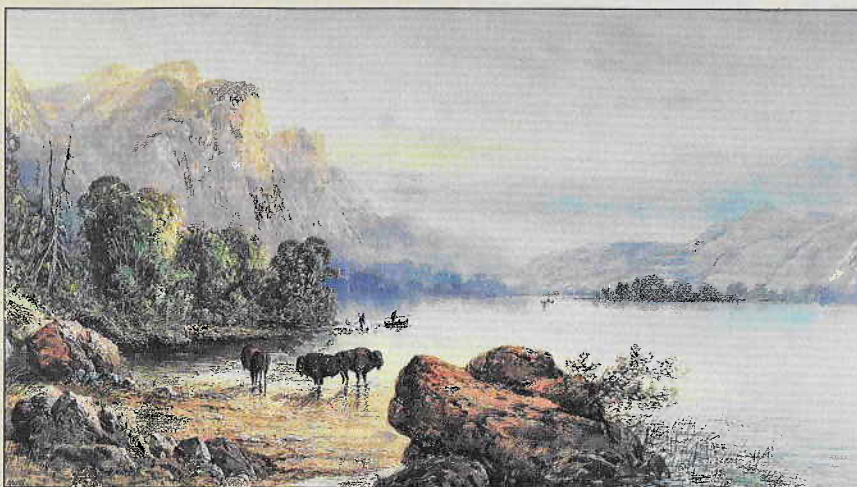
cycle to market takes on average about 30 years for a particular piece of art to appear on the market again,” says McAndrew. “Some might take 100 years. Some never appear again, and some appear quite quickly. But on average, it takes about 30 years. So you’re talking about a really slow, slow market turnover. It’s very opaque, and it’s how dealers make their living.”

### Downsides

Jeffrey Horvitz, vice chairman of the Moreland Management Company, a single-family office headquartered in Cleveland, Ohio, believes that an adviser should first ask the client who wants to start collecting art a very simple question: “Are you nuts?”

“If you’re asking the question, ‘Should I invest in art?’” he continues, “you probably don’t know enough about art to be investing in art.” Horvitz’s statement is based on experience. He was previously an art dealer and a well-known collector who discussed art as an investment at the 2009 CFA Institute Wealth Management conference. (Horvitz’s presentation is available on the CFA Institute website; see “Recommended Resources” for details.)

Numerous factors play a role in valuing art—scarcity, recognizability, and provenance, among others—and a casual collector is highly unlikely to have sufficient reliable information to determine a fair value. Combine the valuation difficulties with market illiquidity, lack of dealer transparency, and the risk of owning an asset whose appeal is subject to fads and the challenge increases. Buying and selling art is also costly. Investors must factor in marketing and insurance fees as well as shipping and storage costs, for example. Recouping transaction costs requires significant appreciation, as an example provided by Horvitz makes clear: Assume an auction-house bidder agrees to pay US\$1.5 million for an item (the “hammer price”). The auction house will add US\$262,500 in commissions (commissions are often negotiable on larger transactions) for a total



David David Gallery, Philadelphia, PA, USA, The Bridgeman Art Library

A Tale of Two 19th Century Landscape Painters. Canvasses of American artist Thomas Moran (1837–1926), who painted the picture above (*Buffalo Watering*, 1887, watercolor on paper), have been valued as high as US\$17.7 million, while the canvasses for French artist Jean Baptiste Camille Corot (1796–1875), whose brush captured the scene below (*A Pond with Three Cows and a Crescent Moon*, c.1850, oil on canvas), hover in the range of a few hundred thousand dollars.



Private Collection, Photo © Lefevre Fine Art Ltd., London, The Bridgeman Art Library

buyer’s cost of US\$1,762,500. The seller will receive US\$1.35 million after deduction of a 10 percent seller’s commission. If that buyer decided to resell the item, a new buyer must agree to pay a total of US\$2.275 million for the seller to break even.

### Art in the Portfolio

Assuming an investor understands the risks and can navigate the market successfully, what role can art play in terms of portfolio characteristics, such as expected returns, volatility, and correlation with other asset classes? The Mei Moses Fine Art Index creates auction-market

statistics, with an overall fine art market index and five submarket indexes. The indexes use the repeat-sale method for objects held at least one year, based on the approach taken with the Case–Shiller real estate indexes. According to Michael Moses, co-founder of the indexes, these categories include more than 15,000 repeat-sale pairs and capture 90–95 percent of the dollar volume of the works sold at Sotheby’s and Christie’s in New York City.

Analysis of art’s performance depends on the submarket and the holding period considered. Over the

*Continued on page 32*

# Private Wealth Management

Did you know that approximately 30% of CFA Institute members are involved in private wealth management? Take a look at what we have to offer.

- BUSINESS DEVELOPMENT TOOLS
- PRIVATE WEALTH MANAGEMENT NEWSLETTER
- EDUCATIONAL EVENTS
- EXCLUSIVE MEMBER BENEFITS
- MULTIMEDIA
- PUBLICATIONS



To learn more, visit [www.cfainstitute.org/privatewealth](http://www.cfainstitute.org/privatewealth)

past 25 years, for example, stocks have substantially outperformed art, but art has outperformed stocks for the past 10 years. Moses believes considering a longer holding period is the correct approach. "We like to use 50 years because we believe that art is a long-cycle type of product—it tends to not disappear," he says. "And we like to use a long period because it has several booms and busts in both the stock market and the art market. If you look at that period, we find that the returns of the S&P 500 with dividends untaxed is about a half point greater than art—they're about the same. We measure risk by looking at the standard deviation of the annual return. At 50 years, the risk of art is slightly less than that of the S&P, and the correlation of art to the S&P is very low. In this last run, it's about -0.02. Prior, it had been running about 0.03, and it's usually negatively correlated with 10-year Treasuries."

McAndrew's book *High Art and High Finance* provides a summary of selected art-price research, and the results indicate a wide range of positive returns based on the market examined in each study. Her own research supports the idea that art can improve a portfolio's risk-return profile. "Using auction data," she explains, "I've looked at various periods. I've looked at art versus commodities versus stocks versus property. And in different periods and

different sectors, it has shown low and negative correlations. And what's attractive is that even in a portfolio of art itself, there are a lot of low correlations and useful pairings and possibilities for holding an internally diversified portfolio of art in itself."

**Luck and Skill**

Most CFA charterholders working with private clients probably lack the degree of expertise in art investment that they have with traditional financial assets. One solution to that problem is to refer clients to art experts. McAndrew notes that the American Appraisers Association provides referrals; the major auction houses also have in-house experts in an assortment of departments. Art consultants can provide valuable advice, but Horvitz cautions that the consultant must work independently for the collector and not receive commissions from art dealers to whom they refer the client. And although dealers can be helpful guides, inexperienced collectors aren't likely to know which dealers they can trust. "The old adage was to buy from a really good dealer," says Horvitz. "Well, if you knew who was a really good dealer, you'd already be 60 percent of the way there." The good news is that properly selected, high-quality art can bring a long-term benefit to clients' portfolios. The bad news is that success-

fully investing in art, as with investing in any asset class, requires specialized expertise. "[Art] requires a meta-expertise—you have to be able to know whom you can trust for that information that you need and whom you can trust for pricing, which is not the same skill set," says Horvitz. "It's not that this can't be done; it's just not something for amateurs. The idea that an amateur can walk into a professional's domain and by just throwing money at the problem somehow get the upper hand is unrealistic. They can't. They may buy something where the market shifts and they get lucky, but you should never confuse luck with skill." ■

*Ed McCarthy is a freelance financial writer in Pascoag, Rhode Island.*

## RECOMMENDED RESOURCES

- Fine Art and High Finance: Expert Advice on the Economics of Ownership* edited by Clare McAndrew (Bloomberg Press 2010)
- The Art Economy: An Investor's Guide to the Art Market* by Clare McAndrew (Liffey Press 2008)
- "The Art Market: A Finance Perspective" CFA Institute webcast by Jeffrey Horvitz ([www.cfawebcasts.org](http://www.cfawebcasts.org))
- The Mei Moses Fine Art Index ([www.artasanaset.com](http://www.artasanaset.com))